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Insights into MFRS 3

Recognition principle

Mergers and acquisitions (business combinations) can have a fundamental impact on the acquirer's operations, resources and strategies. For most entities such transactions are infrequent, and each is unique. MFRS 3 'Business Combinations' contains the requirements for these transactions, which can be challenging in practice. The Standard itself has now been in place for more than ten years and has undergone a comprehensive post implementation review by the Malaysian Accounting Standards Board (MASB).

Our 'Insights into MFRS 3' series summarises the key areas of the Standard, highlighting aspects that are more difficult to interpret and revisiting the most relevant features that could impact your business. This article explains the recognition principles set out in MFRS 3.

Overview of MFRS 3's recognition and measurement principles

The acquisition method requires the acquirer, to recognise and measure the acquiree's identifiable assets acquired and liabilities assumed at their acquisition-date fair values, subject to some exceptions. These assets and liabilities usually include assets and liabilities already reported in the acquiree's financial statements. Applying the acquisition method may, however, also result in recognising assets and liabilities that were not previously reported in the acquiree's financial statements for instance a brand name, a patent or a customer relationship, as the acquiree developed them internally. MFRS 3's recognition and measurement principles should be applied to determine which assets and liabilities to recognise and how they should be measured. The identifiable assets acquired and liabilities assumed should consist of those that:

- belong to the acquiree at the date of acquisition, and
- form part of what has been acquired by the acquirer.

Most, but not quite all, of these assets and liabilities are measured at fair value at the acquisition date – the so called 'fair value exercise'. (The term 'purchase price allocation' is still frequently used to describe this process although it does not perfectly align with the MFRS 3 accounting model).

This fair value exercise is usually a complex and time-consuming step in accounting for a business combination. Many entities engage outside specialists in the valuation area to provide assistance. In most cases this step requires a good knowledge of the business acquired, careful analysis, extensive use of estimates and management judgement in a number of areas.

Refer to our article '**Insights into MFRS 3 – How should the identifiable assets and liabilities be measured?**' which will be released later for more details on the fair value exercise.

Practical insight – The identification exercise

The objective of this exercise is to identify the main items for which the acquirer made the decision to purchase the business. Establishing the core reasons for making the purchase should help to identify the intangible assets acquired, that is, what did the acquirer get in return for the consideration paid and what they were willing to pay for? For example, was it to gain access to a specific technology, to acquire a trademark with a market share (this is usually associated with a technology, a know-how or a process)?

In an acknowledgement of these challenges, MFRS 3 allows a 'measurement period' of up to twelve months from the date of acquisition for the acquirer to complete the initial accounting for the business combination. This is discussed in more detail in our article '**Insights into MFRS 3 – Accounting after the acquisition date**'.

The following three articles in our 'Insights into MFRS 3' series discuss the key activities an acquirer needs to undertake in this step and provides examples to illustrate MFRS 3's requirements:

Requirement	Article
Recognise identifiable assets acquired and liabilities assumed	This article
Measure identifiable assets acquired and liabilities assumed	**Insights into MFRS 3 – How should the identifiable assets and liabilities be measured?** which will be released later
Apply specific recognition and measurement provisions	**Insights into MFRS 3 – Specific recognition and measurement provisions** which will be released later
Classify or designate identifiable assets acquired and liabilities assumed	This article

Applying MFRS 3's recognition principle

Identifiable assets acquired and liabilities assumed in a business combination are recognised (separately from goodwill) if, and only if, they meet MFRS 3's recognition principle at the acquisition date. These assets and liabilities may not be the same as those recognised in the acquiree's own financial statements.

MFRS 3's recognition conditions:
MFRS 3 states from 1 January 2022 at the latest, identifiable assets acquired and liabilities assumed are recognised at the acquisition date if they meet the following definitions of an asset or a liability included in the 'Conceptual Framework for Financial Reporting' issued in 2018:

Asset	Liability
Present economic resource controlled by the entity as a result of past events	Present obligation of the entity to transfer an economic resource as a result of past events

Prior to 1 January 2022, MFRS 3 referred to the MASB's previous conceptual framework. Acquirers were therefore required to apply the definitions of an asset and a liability and supporting guidance in the 'Framework for the Preparation and Presentation of Financial Statements' adopted by the MASB in 2004.

In addition, to qualify for recognition in applying the acquisition method, the identifiable assets acquired and liabilities assumed should be part of what is exchanged between the acquirer and the acquiree (or its former owners) in the business combination (rather than being part of a separate transaction or arrangement). This requires identifying separate transactions that were negotiated at the same time as the business combinations occurred as they should be accounted for separately from the business combination. For example, payments made or expected to be made to the selling shareholders but in consideration of future services that they are committed to render post combination. Refer to our article '**Insights into MFRS 3 – Determining what is part of a business combination transaction**'.

In practice, most of the assets and liabilities to be recognised should fall within familiar MFRS categories, such as:

- cash and cash equivalents
- inventories including work in progress
- financial assets and liabilities, including trade receivables and payables
- prepayments and other assets
- property, plant and equipment
- intangible assets
- income tax payable or receivable
- deferred tax assets and liabilities
- accruals and provisions.

The following two step process can be helpful when identifying the assets and liabilities to recognise:

- determine the population of 'potential' identifiable assets and liabilities from sources such as the acquiree's most recent financial statements, internal management reports and underlying accounting records, due diligence reports and the purchase agreement itself, and
- evaluate these potential identifiable assets and liabilities against MFRS 3's recognition conditions. This determination can be straightforward or may require a detailed analysis depending on the nature of each item. The next section presents some assets and liabilities for which more detailed analysis is often needed.

MFRS 3's identifable assets and liabilities requiring specific attention

The identifiable assets and liabilities to be recognised are unique to each business combination and may differ extensively depending on the industry. However, specific considerations apply to some types of assets and liabilities because of one or more of the following factors:

- MFRS 3 includes specific guidance that is, in some cases, an exception to the general recognition principle discussed above
- these items were not recognised in the acquiree's own financial statements.

The following table summarises examples of the types of identifiable assets and liabilities that will often require specific attention and for which specific guidance exists in MFRS 3:

Items requiring analysis	Specific guidance
Intangible assets	In order to be recognised separately from goodwill, an intangible asset should be identifiable, ie meets either the separability or the contractual-legal criteria. This identification process can be challenging and often requires judgement (see page 7).
Restructuring plans	A restructuring plan is recognised only if the acquiree has an obligation at the acquisition date to incur the restructuring costs. Costs the acquirer expects to incur as a result of its own post-combination decisions are not liabilities at the acquisition date and should be recognised in post-combination earnings. See the section on recognising restructuring plans presented on page 11 for more details regarding the recognition principles for restructuring plans.
Contingent liabilities*	A contingent liability is recognised if it is a present obligation that arises from past events and its fair value can be measured reliably.
Deferred taxes*	The acquirer does not recognise the acquiree's historical deferred tax balances but determines new amounts based on the identifiable assets and liabilities recognised in the acquisition accounting and the requirements of MFRS 112 'Income Taxes'.
Leases in which the acquiree is the lessee*	The acquirer should recognise right-of-use assets and lease liabilities for leases in the business combination that have been identified in accordance with MFRS 16 'Leases'.
Employee benefits*	The acquirer applies the specific requirements of MFRS 119 'Employee Benefits' to determine the liabilities (or assets, if any) to be recognised for any assumed post-employment benefit plans and other post-retirement benefit plans.
Indemnification assets*	If the seller agreed to contractually indemnify the acquirer for the outcome of a particular uncertainty that may affect the amount of an asset or a liability, an indemnification asset is recognised on a basis that is consistent with how the indemnified item is recognised at the acquisition date.
Reacquired rights*	If the acquirer previously granted a right to the acquiree to use the acquirer's intellectual property or other asset (such as a trade name or licensed technology), a separate 'reacquired right' intangible asset is recognised even if the underlying asset was not previously reported.

* Specific guidance on these items are discussed in more detail in our article '**Insights into MFRS 3 – Specific recognition and measurement provisions**' which will be released later.

Examples of other items requiring specific attention but for which no specific guidance is provided in MFRS 3 include:

Items requiring analysis	Specific considerations
Acquiree's previous goodwill	The acquirer does not recognise goodwill recognised by the acquiree from a past business combination. Instead, a new goodwill amount (or gain from a bargain purchase, as the case may be) should be calculated and recognised at the acquisition date. This is discussed in more detail in our article **'Insights to MFRS 3 – Recognising and measuring goodwill or gain from a bargain purchase'**.
Liability and equity accounts	Financial instruments issued by the acquiree to third parties need to be classified as liabilities or equity instruments (or if compound instruments a split between the two classifications) based on MFRS 132 'Financial Instruments: Presentation' and conditions at the acquisition date. In other words, no matter how the instruments are presented in the statement of the financial position of the acquiree, it will be presented in the financial statements of the acquirer based on the contractual terms assessed on the basis of the pertinent conditions as they exist at the acquisition date. The change of ownership could change the classification and/or trigger specific clauses in contractual agreements. Equity 'reserves' such as retained earnings and revaluation reserve are not identifiable assets or liabilities. Equity instruments of the acquiree held by non-controlling parties may affect goodwill and may require more analysis.
Deferred revenue	Deferred (unearned) and accrued revenue balances that arise from application of the acquiree's revenue recognition policies should be analysed to determine if an underlying asset or liability exists at the acquisition date and, if so, how it should be recognised in the combination. Specifically, an acquiree's contract liability (ie deferred revenue) relating to a contract with a customer, is a liability from the acquirer's perspective if the acquiree has received consideration (or the amount is due to be received) from the customer but has not satisfied the related performance obligation. In addition, sometimes a contract liability may relate to a situation where the performance obligation has been satisfied either partially or totally but revenue has not been recognised yet by the acquiree because of the variable consideration constraint.

Recognising identifiable intangible assets: what MFRS 3 permits

It is important to identify intangible assets separately because, in most cases, their useful lives will be finite, which means an amortisation expense should be recognised by the acquirer to comply with the requirements set out in MFRS 138 'Intangible Assets'. Separate recognition therefore affects post-combination earnings and the more intangibles with finite useful lives that are recognised separately from goodwill, the more their identification will affect the earnings of the acquirer. Partly for this reason, MFRS 3's approach places a strong emphasis on separate recognition rather than subsuming intangibles within goodwill.

However, identifying intangible assets is inherently more difficult and subjective than identifying physical assets such as inventory and property. In addition, many intangibles recognised in a business combination may not have been recognised in the acquiree's own financial statements.

Specific recognition requirements

Intangible assets acquired in a business combination are recognised separately from goodwill if they:

- meet MFRS 3's general recognition principle (see above), and
- are identifiable.

Identifiable has a specific meaning in this context and is based on guidance set out in MFRS 138. An acquired intangible asset is identifiable if it meets either of the following criteria:

'Identifiable'		
Contractual-legal		**Separable**
Arising from contractual or legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.	OR	Capable of being separated or divided from the acquiree and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, identifiable asset or liability.

Applying the specific recognition requirements

The identifiable intangible assets acquired will depend on the nature of the business, its industry and other specific facts and circumstances of the combination. It is useful to divide the identification process into two steps:

Step 1	Identify the population of 'potential' intangibles
Step 2	Assess each against MFRS 3's specific criteria

Potential intangible assets

Potential intangible assets, items that are non-monetary without physical substance, arising from contractual or legal rights, such as trademarks and licences, may be detected based on analysis of applicable contracts or agreements.

Non-contractual intangible assets, such as customer relationships and in-process research and development, can require more analysis. Possible indicators and information sources include:

Sources of Information	Possible indicators
Acquiree's financial statements and other internal reports	• Some intangible assets will have been recognised in the acquiree's financial statements. Other financial statement information may also provide indirect indicators, for example: – significant marketing costs may be an indicator of the relative importance of brands, trademarks and related intangible assets – significant expenditures on research and development may indicate the existence of technology-based intangible assets – significant expenditures related to customer care may point to customer relationship assets, or – governments grants relating to specific research and development expenditure, as well as forgivable loans, which repayment is based on a royalty mechanism.
Purchase agreement and accompanying documents (licencing agreements)	• May include references to certain trademarks, patents or other intangible assets that are established by contract or legal rights, and • May include non-compete provisions that sometimes give rise to a potential intangible asset.
Due diligence reports	• May include information that assists in understanding the acquired business, resources and how revenues are generated.
Website materials, press releases and investor relation communications	• The website may contain discussions of the unique characteristics of the business which may translate into a potential intangible asset, and • Press releases and investor relation communications of both the acquiree and the acquirer may include discussions of potential intangible assets.
Industry practice	• Results of similar business combinations may provide indicators of the types of intangible assets that are typically recognised in such situations.

Determining whether a potential intangible asset is identifiable

Each potential intangible asset (ie a non-monetary item without physical substance) should be assessed to determine if it is 'identifiable'. As noted, intangible assets arising from contracts or agreements will always meet this test.

For other potential intangible assets an assessment of 'separability' is required. This is based on whether the item can be sold or otherwise transferred, without selling the entire business. Examples of these considerations are as follows:

- it is a hypothetical assessment and is not dependent on any intention to sell (although a sale plan, if one exists, demonstrates separability)
- actual exchange transactions for the type of potential intangible assets being analysed or a similar type indicate separability, even if those transactions are infrequent and regardless of whether the acquirer is involved in them
- in order to be separable, the potential intangible asset need not be saleable on its own. It could be transferred in combination with a related contract, identifiable asset or liability. However, if separation is only possible as part of a larger transaction, judgement is required to determine whether the potential sale is of the entire business or only part of it
- the terms of the purchase agreement or related agreements may prohibit the transfer of certain intangible assets (eg confidentiality agreements prohibiting transfer of customer information), and
- the legal and regulatory environment may prevent the transfer of intangible assets without underlying contractual or legal rights.

Example 1 – Database used in a supporting activity

Entity Q acquired Entity R, a retailer. Entity R owns a database, used in managing its loyalty scheme, which captures information on customer demographics, preferences, relationship history and past buying patterns. The database can either be sold or licensed. However, Entity R has no intention to do so because it will negatively impact its operations.

Analysis

In this situation, the database does not arise from a contractual or legal right. Thus, an assessment of its separability is required. The database and content were generated from one of Entity R's supporting activities (ie management of the loyalty scheme) and could be transferred independently of the rest of the business. The actual intention not to transfer the database does not affect the assessment. The separability criterion is met and the database is recognised as an intangible asset in the business combination.

Note – the intention not to use the database should not affect its recognition as a identifiable intangible asset, nor should it affect its measurement (ie fair value). This is covered in our article '**Insights into MFRS 3 – How should the identifiable assets and liabilities be measured?**' which will be released later.

Example 2 – Complementary intangible assets

Entity X acquired the food manufacturing division of Entity Y, which includes a registered trademark for a certain product and an associated secret recipe for the product. Access to the secret recipe is required to enable the product to be manufactured and reasonable steps are taken to maintain its secrecy. The recipe is not protected by legal rights.

Analysis

The trademark is recognised as a separate intangible asset – as this is based on a legal right.

The secret recipe is not covered by the trademark registration and is not otherwise protected by legal rights. Its separability is therefore assessed. It is probably not feasible to transfer the recipe without the trademark, or vice versa, and the value of the trademark may rely upon the recipe itself. It is however likely to be feasible to transfer the recipe and trademark together without transferring the entire business. If so, the secret recipe meets the separability criterion and is recognised as a separate intangible asset. However, the recipe may be grouped with the trademark for presentation and measurement purposes if their useful lives are similar.

MFRS 3 provides other examples of intangible assets that meet either the separability or the contractual-legal criterion. In addition, MFRS 3's Illustrative Examples provide a list of the common types of identifiable intangible assets that may be acquired in a business combination and these have been summarised below. This list is not exhaustive.

Artistic-related intangible assets

- plays, operas and ballets
- books, magazines, newspapers and other literary works
- musical works such as compositions, song lyrics and advertising jingles
- pictures and photographs
- video and audio-visual material, including films, music videos and television programmes.

Contract-based intangible assets

- advertising, construction, management, service or supply contracts
- licensing, royalty and standstill agreements
- lease agreements
- construction permits
- franchise agreements
- operating and broadcasting rights
- use rights such as drilling, water, air, mineral, timber-cutting and route authorities
- servicing contracts such as mortgage servicing contracts
- employment contracts that are beneficial contracts from the perspective of the employer because the pricing of those contracts is below the current market value.

Marketing-related intangible assets

- trademarks, trade names, service marks, collective marks and certification marks
- internet domain names
- trade dress (unique colour, shape or package design)
- non-compete agreements.

Customer-related intangible assets

- customer lists*
- order or production backlog
- customer contracts and the related customer relationships
- non-contractual customer relationships*

Technology-based intangible assets

- patented technology
- computer software and mask works
- unpatented technology*
- databases*
- trade secrets such as secret formulas, processes or recipes.

* These items are usually considered as identifiable intangible assets because they meet the separability criterion. All other items usually satisfy the contractual-legal criterion.

MFRS 3’s guidance on recognising restructuring plans

An acquirer recognises liabilities for restructuring or exit activities acquired in a business combination only if they meet the definition of a liability at the acquisition date, as follows:

- recognising a restructuring provision as part of the acquiree’s liabilities requires that the acquiree has a constructive obligation to restructure at the acquisition date. This may only arise when the acquiree has developed a detailed formal plan for the restructuring and either raised a valid expectation with those affected that it will carry out the restructuring by publicly announcing details of the plan or demonstrating that it has begun implementing the plan. Such a liability is recognised when it becomes probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- a restructuring plan that is contingent on the business combination being consummated is not a liability of the acquiree at the acquisition date
- similarly, a restructuring that the acquirer arranges to be implemented by the acquiree within the context of the business combination is not a liability of the acquiree at the acquisition date.

Although the standard no longer contains the explicit requirements relating to restructuring plans, the Basis for Conclusions clearly indicates that the requirements for recognising liabilities associated with restructuring or exit activities remain the same.

Items not meeting MFRS 3's recognition conditions

In many business combinations, the acquirer will detect other items or resources that are valuable to the acquired business. However, not all of them meet MFRS 3's recognition conditions, for example:

Assembled workforce	• An assembled workforce is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. It is not considered to be identifiable. MFRS 138 also points out that there is usually insufficient control over the economic benefits that may result from the assembled workforce. • Because an assembled workforce is a collection of employees rather than an individual employee, it does not arise from contractual or legal rights. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. • In addition, an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset or liability. An assembled workforce cannot be sold, transferred, licensed, rented or otherwise exchanged without causing disruption to the acquirer's business.
Potential contracts	• Potential contracts are not assets at the acquisition date even though the acquirer attributes value to those contracts (via goodwill) the acquiree is negotiating with prospective new customers at the acquisition date. The acquirer should not subsequently reclassify the value of those contracts from goodwill for events that occur after the acquisition date for instance by separately recognising an intangible asset.
Synergies	• Synergies are usually not identifiable as they do not depend on contractual or other legal rights and they are usually not capable of being separated from the acquired entity. They are identified as one of the component of goodwill and should be subsumed in it.
Market share, market potential, monopoly situations or similar 'strategic values'	• A robust position in the market may enhance the value of identifiable marketing-related or technology-driven intangible assets. However, the acquiree's market share or market condition is not a controllable future economic benefit.
High credit rating or going concern	• Value is sometimes attributed to a high credit rating or other indicators of the sustained ability of the acquiree to operate as a going concern. However, these values are not controllable future economic benefits.
Contingent assets	• A contingent asset represents a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not in control of the entity. An acquirer does not recognise a contingent asset at the acquisition date as it does not meet the definition of an asset in accordance with the Conceptual Framework for Financial Reporting.

MFRS 3's requirement to classify or designate identifiable assets acquired and liabilities assumed

The accounting for identifiable assets and liabilities depends on how they are classified and designated. The acquisition method requires the acquirer to classify and designate acquired assets and liabilities based on contractual terms and economic conditions at the acquisition date. This also takes into account:

- the acquirer's operating or accounting policies
- the intentions of the business going forward, and
- other pertinent conditions.

Therefore, the acquirer's classifications and designations may differ from those of the acquiree before the combination.

MFRS 3 provides a non-exhaustive list of examples of the classification or designation of acquired assets and liabilities, as follows:

- classification of particular financial assets and liabilities in accordance with MFRS 9 'Financial Instruments'
- designation of a derivative instrument as a hedging instrument in accordance with MFRS 9, and
- assessment of whether an embedded derivative should be separated from the host contract, which will be dependent on the classification of the host contract in accordance with MFRS 9.

The scope of this requirement is potentially broad and a large number of items may need to be assessed. In practice, the most significant area is often financial instruments, including classification in accordance with IAS 39 or MFRS 9, assessment of embedded derivatives and hedge accounting. Particular attention may need to be paid to the acquiree's hedge accounting designations (if any). The acquiree's original designations cannot be continued in the acquirer's post-combination financial statements. New designations are therefore required if the acquirer wishes to apply hedge accounting. These new designations may be susceptible to greater hedge ineffectiveness because the acquired hedging instruments (derivatives in most cases) are probably no longer 'at market'.

MFRS 3 provides an exception to this general principle concerning leases, this is for the classification of a lease contract in which the acquiree is the lessor as either an operating lease or a finance lease in accordance with MFRS 16 'Leases'. In this situation, the acquirer classifies leases on the basis of the contractual terms and other factors that existed at the inception of the contracts.

MFRS 3 also currently provides this same exception for the classification of contracts as insurance contracts (under MFRS 4 'Insurance Contracts'). Similar to leases the acquirer classifies these contracts on the basis of the contractual terms and other factors that existed at the inception of the contracts. When MFRS 4 is replaced by MFRS 17 'Insurance Contracts' this exception on classification will be removed and a new measurement exception will have to be applied. This new measurement exception is presented in our article '**Insights into MFRS 3 – Specific recognition and measurement provisions**' which will be released later.

How we can help

We hope you find the information in this article helpful in giving you some insight into MFRS 3. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact..